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IN THE

Supreme Court of the United States

OCTOBER TERM 1942

No. 239

JAMES A. RHEINSTROM, Executor under the Will of Minna W. Rheinstrom, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

No. 240

FIRST NATIONAL BANK, Cincinnati, Ohio, Trustee under the Will of Karl Kiefer, deceased,

Petitioner,

v.

THOMAS J. CONNER, Collector of Internal Revenue,

Respondent.

PETITION FOR WRITS OF CERTIORARI TO REVIEW JUDGMENTS OF THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE SIXTH CIRCUIT

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PETITION FOR WRITS OF CERTIORARI

To the Honorable Chief Justice and Associate Justices of the United States:

SUMMARY STATEMENT OF THE MATTER INVOLVED

This petition involves the interpretation of Section 115 (a), (b), (c), (g) and (i) of the Internal Revenue Code, i.e. what is or is not a distribution in partial liquidation and therefore not taxable as income. The distribution

here arose out of the reduction in capital and complete cancellation of part of an original issue of stock which occurred in 1914, long before the passage of Section 115 or its predecessors. There therefore could not have been any scheme, plan or motive which could have any relation to an avoidance of any tax. Section 115 (g), in order to make the distribution taxable, requires the *cancellation* to take place at such time and in such manner as to make the cancellation and distribution essentially equivalent to the distribution of a taxable dividend.

Moreover, Section 115 (g), on which the Circuit Court of Appeals below based its decision, was not in issue, argued, briefed, or even mentioned by anyone before the decision of that Court. Rehearing on this ground was denied, contrary to the rule laid down by decisions of this Court.

Your petitioners sued the respondent in separate actions in the United States District Court for the Southern District of Ohio, to recover excess income taxes paid for the calendar year 1934, arising out of certain payments made to their respective decedents, by The Karl Kiefer Machine Company, a corporation, in that year. Both cases involved issues arising out of the same transactions, and were, although separately tried, submitted together to the Court without a jury. One Findings of Fact and Conclusions of Law was made for both cases (R. 60-67, 87). Judgment was rendered for the respondent in each case (R. 67, 88). By stipulation the cases were presented on the same record upon appeal to the United States Circuit Court of Appeals for the Sixth Circuit (R. 89, 94) and were decided together by that Court (R. 94). The judgments of the District Court were affirmed (R. 93, 94).

The Karl Kiefer Machine Company, an Ohio corporation, was organized in 1908 with an authorized capital of

$500,000, consisting of 3000 shares of common stock, par value $100, and 2000 shares of preferred stock, par value $100; on November 28, 1914, 1500 shares of the common stock, and 420 shares of the preferred stock were fully paid up, issued and outstanding, the total paid-in capital as of that date thus being $192,000. At that time, Karl Kiefer, now deceased, was the owner of 748 shares of the common stock, and Mrs. Rheinstrom, now deceased, was the owner of 748 shares of the common stock, the remaining four shares of common stock being in the names of others to qualify them as directors (R. 14-15, 80). All of the preferred stock was owned by Karl Kiefer (R. 83).

On November 28, 1914, at a special meeting of the stockholders of the company, at which all its outstanding stock was represented, it was unanimously resolved that the capital stock be reduced from $500,000 to $70,000, to consist of $42,000 preferred stock divided into 420 shares at $100 each, and $28,000 common stock divided into 280 shares at $100 each (R. 15, 81). On November 30, 1914, the Board of Directors of the company approved the action of the stockholders (R. 16, 81-82). Thereafter a certificate of reduction of capital stock was filed in the office of the Secretary of State, Columbus, Ohio, and on December 1, 1914, that officer issued his certificate showing that the reduction of the capital stock of the company had been made and recorded in his office (R. 17-18, 82-83).

Upon the filing of the certificate of reduction of capital stock, certificates representing 1496 shares of common stock of the Karl Kiefer Machine Company, being the 748 shares each owned by Minna W. Rheinstrom and Karl Kiefer, were delivered to the company and cancelled; new certificates for 276 shares of common stock of the par value of $100 each were issued by the company, certificates for 138 shares thereof being issued to Mrs. Rheinstrom, and

a like number to Karl Kiefer (R. 18, 83). The remaining four shares of the 280 shares of reduced common stock were beneficially owned, two shares each, by Mrs. Rheinstrom and Karl Kiefer, but were in the name of other persons to qualify them as directors (R. 80). Thus Mrs. Rheinstrom and Karl Kiefer each was the real owner of one-half of the common stock both before and after the reduction of capital, each returning a net of 610 shares of common stock for cancellation to the corporation. Karl Kiefer owned the entire outstanding preferred stock, which remained unchanged, namely 420 shares, both before and after the reduction in capital (R. 83).

The minutes of the meetings of the stockholders and directors of the Karl Kiefer Machine Company which record the action by which the reduction of its capital stock was accomplished are silent as to the motive which led to the taking of this action (R. 15-16, 81-82). At the trial, James Rheinstrom, who was a stockholder, director and secretary of the company in 1914, and who moved the adoption of the resolutions reducing the stock, proposed to testify that the purpose of the stockholders and directors in reducing the stock was to free that portion of the capital for the stockholders' use at any time they should desire to draw down this money (R. 31-32), but such testimony was excluded by the Court as in violation of the parol evidence rule (R. 30, 31, 41).

Karl Kiefer died on April 16, 1931, and under the provisions of his will, petitioner, the First National Bank as Trustee was left one-third of his estate in trust, to pay the income thereof to Adele Kiefer for life, and on her death to pay the principal to designated remaindermen (R. 84).

In 1934 in addition to paying to its stockholders as declared dividends from earnings on common stock the sum of $90,000.00, the Karl Kiefer Machine Company paid to Mrs. Rheinstrom and to the legatees of Karl Kiefer the

sum of $122,000 which it considered was in repayment for the cancellation of the 1220 shares of common stock (Pl. Exs. 5, 6-A, 6-B, 7), of which, $61,000, representing the 610 shares of her $100 par value common stock which had been cancelled, was paid to Mrs. Rheinstrom, and $20,333.33, or one-third of the $61,000 due Karl Kiefer for his 610 shares of similar stock, was paid to the petitioner bank as trustee under the will of Karl Kiefer (R. 14, 84-85).

It is conceded by petitioners that at the time this distribution was made, the corporation had on hand more than sufficient accumulated earnings since February 28, 1913, from which it could have made payments of like amounts.

When Minna W. Rheinstrom and the trustee bank received the sums of $61,000 and $20,333.33 respectively from the Karl Kiefer Machine Company, in 1934, they did not regard it as income; on the contrary they considered it as return of capital, that is, repayment by the company of the capital which had been used to purchase the common stock which they had owned and surrendered in 1914 pursuant to the resolutions heretofore referred to (R. 14-18, 80-85). Thereafter, however, respondent required them to file amended returns so as to include those sums as income for the year 1934 (R. 14, 85), claiming that the distributions in question were dividends from earnings under subsections (a) and (b) of Section 115 of the Revenue Act of 1934.

The Commissioner of Internal Revenue, however, in the case of another stockholder, Adele Kiefer, conceded upon her protest, that the distribution to the trustee bank was principal under the trust, and therefore not taxable to her as the life tenant entitled to receive all income under the trust (R. 59-60, 87).

Additional income taxes were paid on the respective amounts distributed, $24,528.39 by Mrs. Rheinstrom and $1310.95 by the trustee bank. Claims for refund were duly

filed with, and rejected by, the Commissioner of Internal Revenue. Mrs. Rheinstrom died, and these suits were accordingly brought.

OPINION OF THE COURTS BELOW

Opinion of the District Court

The District Court (Druffel, J.) in granting judgments for the respondent, adhered to its decision made during the trial, excluding the proffered evidence as to the purpose of the reduction in capital, saying in effect that the Court would not have been persuaded by it even if it had been admitted. The Court then held that the reduction of capital and cancellation of the 1220 shares of common stock effected no real change in the capital structure of the corporation or in the relative positions of the stockholders; further, that since winding up of the business was not contemplated, the cancellation of stock and subsequent distribution was not a "partial liquidation" under subsection (i) of Section 115 of the Revenue Act of 1934, and finally, that since the corporation had sufficient accumulated earnings since February 28, 1913, on hand from which to make the payment, under subsections (a) and (b) of Section 115, distribution of the $122,000 must be conclusively presumed to be dividends from earnings. The opinion of the District Court is found R. 60-67, and is reported in *33 Fed. Supp. 917 (1940)*.

Opinion of the Circuit Court of Appeals

The Circuit Court of Appeals in its opinion (McAllister, J.) unfortunately talks all around the various points it discusses, but seems unwilling to make forthright commitments of its own. This much, however, can be gleaned therefrom: The Circuit Court of Appeals affirmed the District Court not on any ground ever urged or even men-

tioned by the Government or by the District Court, but *sua sponte* found as a fact that the cancellation and distribution were essentially equivalent to a distribution of a taxable dividend under subsection (g) of Section 115; considered that the motive behind the cancellation, even if not tax avoidance, was immaterial, and ruled that the distribution was taxable. The Court also held that the exclusion of the proffered testimony of the purpose of the reduction in capital was harmless, because the District Court referred to it in its opinion, and because petitioner's counsel contended that even without evidence of the actual purpose, as a matter of law the fund created by the reduction in capital and cancellation of the stock belonged to the stockholders anyway. The Court likewise decided that the distribution was not in partial liquidation or properly chargeable to capital account under subsections (i) and (c) of Section 115.

The opinion of the Circuit Court of Appeals appears R. 94-105, and is reported in *125 Fed. (2d) 790 (1942)*.

Both the District Court and the Circuit Court of Appeals avoided passing upon the trustee bank's contention that the tax on the share of the distribution it received in effect charged remaindermen entitled to principal only with an income tax on funds conceded by the Government to belong to principal account, and therefore constituted a tax on capital, violating due process of law and the apportionment requirements of *Article I, Section 2, Clause 3, and Section 9, Clause 4*, of the Federal Constitution.

JURISDICTIONAL STATEMENT

The decision and judgments of the United States Circuit Court of Appeals for the Sixth Circuit, affirming judgments of the District Court against the petitioners, were handed down February 13, 1942 (R. 93, 94). On March 14, 1942, less than thirty days thereafter, petitioners duly filed their

Petition for Rehearing with said Circuit Court of Appeals (R. 107). On April 17, 1942, said petition for rehearing was denied (R. 139). This petition was filed in the Supreme Court of the United States less than three months after said last date. This is a petition for writs of certiorari to review the judgments of the United States Circuit Court of Appeals for the Sixth Circuit in both cases, and is authorized by *Section 240(a)* of the *Judicial Code*, as amended by the *Act of February 13, 1925, c. 229, § 1, 43 Stat. 938* [*28 U. S. C. A. § 347(a)*].

STATUTE INVOLVED

The meaning of Section 115 of the Revenue Act of 1934 is in issue and that section is found beginning p. 23 of Appendix A to this petition.

QUESTIONS PRESENTED

1. May a Circuit Court of Appeals in an action at law, decide the appeal on an issue raised *sua sponte* by that court although not raised at any time by either party or by the lower court, and may the Circuit Court of Appeals go still farther and base its *sua sponte* ground on conclusions of fact made by it but not found by the lower court? Does such action by the Circuit Court of Appeals violate due process of law?

2. Is the purpose or motive for cancellation of part of an issue of stock material in determining whether or not such cancellation and subsequent distribution are essentially equivalent to the distribution of a taxable dividend under paragraph (g) of Section 115 of the Revenue Act of 1934?

3. Is paragraph (g) of Section 115 of the Revenue Act of 1934 applicable to a cancellation of stock *not issued as a stock dividend* where such cancellation occurred prior to January 1, 1926?

4. Is contemplation of closing out of a business necessary in order to have a distribution in partial liquidation under Section 115(i) of the Revenue Act of 1934?

5. Where a corporation reduces its capital and cancels part of its outstanding par value common capital stock, and some years later distributes to the holders thereof such par value in cash, is such distribution a return of capital?

6. If the corporation has on hand accumulated earnings since February 28, 1913, sufficient to make the payments, is such a distribution taxable under paragraphs (a) and (b) of Section 115 of the Revenue Act of 1934, or nevertheless not taxable as a distribution in partial liquidation and properly chargeable to capital account, under paragraphs (c) and (i) of the same Section?

7. Where a taxpayer claims that capital was reduced and cancellation of a part of an issue of stock was made in good faith and not for the purpose of evading a tax on dividends, but to make the capital thus freed available to the stockholders, can the Government raise the bar of the parol evidence rule against parol testimony of the purpose of the directors and stockholders in reducing the capital and cancelling the stock? Can exclusion of such evidence be held non-prejudicial merely because the trial judge says it would not have persuaded him even if admitted?

8. Does it violate due process of law and the apportionment requirements of *Article I, Section 2, Clause 3, and Section 9, Clause 4,* of the Federal Constitution, to cast the burden of an income tax on dividends upon remaindermen under a trust who are not entitled to receive dividends but entitled to receive capital only?

REASONS FOR ALLOWANCE OF THE WRITS

I

(a) The Circuit Court of Appeals below has so far departed from the accepted and usual course of judicial

proceedings as to call for an exercise of this Court's power of supervision in that the Circuit Court of Appeals decided the appeals in these cases on an issue raised *sua sponte* by it, although never urged or even mentioned at any time by either side or by the lower court. The Government's contention and the basis of the trial court's decision were that the reduction in capital effected no real change in the corporate structure or in the relative positions of the stockholders and that subsections (a) and (b) of Section 115 created a conclusive presumption in favor of the respondent. The Court of Appeals decided these cases upon the ground that the cancellation of stock and subsequent distribution occurred at such time and in such manner as to be essentially equivalent to the distribution of taxable dividends under paragraph (g) of Section 115 of the Revenue Act of 1934. Such contention had never been made in the cases at any time by the Government, either in the Department, the District Court, or in the briefs or argument in the Circuit Court of Appeals.

The pleadings in the case in the trial court appear at R. 1-13, 71-79. The opinion of the trial court is found at R. 60-67. The briefs filed in the Circuit Court of Appeals have been submitted as Appendix B to this petition. The Court can see by examining all the foregoing that the first time paragraph (g) of Section 115 was brought into the case was in the opinion of the Circuit Court of Appeals (R. 97). The petitioners never had the opportunity to meet such a contention. This was pointed out in petitioners' petition for a rehearing in the Court below (R. 123-4), but said petition was denied.

The action of the Court below deprived petitioners of due process of law and went contrary to the decisions of this Court in the cases of *Lutcher & M. Lbr. Co.* v. *Knight*, 217 U. S. 257, 267, 30 S. Ct. 505, 54 L. Ed. 757, 761 (1910); *West Ohio Gas Co.* v. *Public Utilities Com.*, 294 U. S. 63,

70, 55 S. Ct. 316, 79 L. Ed. 761 (1934); *General Utilities Co.* v. *Helvering*, 296 U. S. 200, 206, 56 S. Ct. 185, 80 L. Ed. 154 (1935).

(b) Further, the Circuit Court of Appeals exceeded its powers in that it based its decision upon a conclusion of fact found by it for the first time, although no such facts were found by the trial court.

The Circuit Court of Appeals found as a fact that the cancellation of the stock and distribution were essentially equivalent to a distribution of a taxable dividend. That this is a question of fact was decided in *Commissioner* v. *Babson*, 70 Fed. (2d) 304, 305, 306 (C. C. A. 7). As the Court can see from reading the findings of the trial court (R. 60-67), the trial court made no finding whatever in respect to any such contention. This Court has held on several occasions that the Appellate Court has no power in appeals in actions at law to make findings of ultimate fact which were not found by the trial court.

Helvering v. *Rankin, Executor*, 295 U. S. 123, 131, 55 S. Ct. 732, 79 L. Ed. 1343 (1935);
Commissioner v. *Pfeiffer*, 88 Fed. (2d) 3, 5 (C. C. A. 2, 1937), affirmed, 302 U. S. 247, 82 L. Ed. 231, 58 S. Ct. 159.

It is submitted that the action of the Circuit Court of Appeals presents very important questions of procedure and due process, and such action was contrary to the principles laid down in the decisions of this Court above cited.

II

The decision of the Circuit Court of Appeals is in conflict with the decisions of other Circuit Courts of Appeal on the same question. In the cases at bar, the cancellation of the stock occurred in 1914, long before the passage of Section 115, or any of its predecessors, and therefore, obviously, there could have been no motive of tax avoid-

ance behind the cancellation. Indeed, the Government has never so contended. Nevertheless, the Court below held that Section 115(g) was applicable to the case at bar. There is a conflict in the Circuits on the point of the materiality of motive to the question of the applicability of paragraph (g) of Section 115. The Circuit Court of Appeals referred to this conflict (R. 97, et seq.).

The Third and Fourth Circuits and the Court of Appeals of the District of Columbia and in some cases the Seventh Circuit have held motive immaterial.

Flanagan v. *Helvering*, 116 Fed. (2d) 937 (App. D. C., 1940);
Smith v. *U. S.*, 121 Fed. (2d) 692 (C. C. A. 3, 1941);
Hill v. *Commissioner of Int. Rev.*, 66 Fed. (2d) 45, (C. C. A. 4, 1933);
McGuire v. *Commissioner*, 84 Fed. (2d) 431 (C. C. A. 7, 1936).

The First and Second Circuits and in other cases the Seventh Circuit, however, have held to the contrary, holding that in order to make paragraph (g) of Section 115 applicable, the cancellation must be part of a scheme to avoid the distribution of taxable dividends.

Commissioner v. *Brown*, 69 Fed. (2d) 602, 603, 604 (C. C. A. 7, 1934);
Commissioner v. *Rockwood*, 82 Fed. (2d) 359, 361 (C. C. A. 7, 1936);
Commissioner v. *Cordingley*, 78 Fed. (2d) 118, 120 (C. C. A. 1, 1935);
Commissioner v. *Quackenbos*, 78 Fed. (2d) 156, 158 (C. C. A. 2, 1935);
Patty v. *Helvering*, 98 Fed. (2d) 717, 719 (C. C. A. 2, 1938).

The Circuit Court of Appeals of the Second Circuit, in the last case cited, referring to the conflict in the Circuits, stated at p. 719 as follows:

". . . We shall continue to follow *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156, until the Supreme Court makes authoritative a different interpretation."

In view of the conflict in the Circuits and the recognition of the conflict by the various Circuit Courts of Appeal, it is submitted that this Court should resolve the conflict and settle the proper interpretation to be given to paragraph (g) of Section 115.

III

The Court below has decided an important question of Federal law which has never been, but should be, settled by this Court, to-wit: whether paragraph (g) of Section 115 of the Revenue Act of 1934, or its predecessors beginning in 1926 and its successors, are applicable to distributions made pursuant to cancellations of *stock not originally issued as a stock dividend*, where the cancellations occurred prior to January 1, 1926. The Court below held paragraph (g) of Section 115 applicable to the transaction in the case at bar, although the cancellation of stock not originally issued as a stock dividend occurred in 1914, long before January 1, 1926.

Prior to January 1, 1926, paragraph (g) of Section 115 (then Section 201) and its predecessors were applicable only to a cancellation or redemption of stock previously issued as a stock dividend. The Section was amended in the Revenue Act of 1926 to include cases where stock not issued as a stock dividend was redeemed or canceled, but the following exception was added:

"In the case of a cancellation or redemption of stock not issued as a stock dividend, this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926."

This exclusion was intentional as is seen from the Congressional Committee Reports. *Sen. Rep. 52, 69th Cong., 1st Sess. p. 15; House Rep. 356, 69th Cong. 1st Sess. p. 30.*[1]

The same language is carried in subsequent revenue acts up until the Revenue Act of 1932, where Congress felt that the same intention was taken care of by other language in the Act. *Vol. 2, House Rep., 72nd Cong. 1st Sess. Rep. No. 708, p. 31.*[2] The Revenue Act of 1934 followed the same scheme as that of 1932. *House Rep. 73rd Cong. 2nd Sess. Vol. 2, Rep. No. 704, p. 20; Sen. Rep. 73rd Cong. 1st and 2nd Sess. Vol. 1, Rep. No. 558, p. 21.*[3]

This highly important question of interpretation of the Revenue Acts of 1926 and thereafter has not been decided by this or any other court, to our knowledge.

IV

The decision of the Circuit Court of Appeals below is in conflict with the decision of another Court of Appeals and the Board of Tax Appeals on another question. Fur-

---

[1] The exclusion was not in the original House Bill but was added by the Senate. *Senate Rep. 52, p. 15, 69th Cong. 1st Sess.* In Conference the House receded and in the House Conference Committee report, *House Rep. 356, p. 30, 69th Cong., 1st Sess.*, we find with reference to Section 201(g):

> "This Amendment provides that in the case of cancellation or redemption of stock not issued as a stock dividend, this subdivision shall apply only if the cancellation or redemption is made after January 1, 1926, and the House recedes."

[2] "Under the existing law the provisions of Section 115(g) were made applicable in the case of the cancellation and redemption of stock not issued as a dividend, only if the cancellation or redemption was made after January 1, 1926.

"This provision was inserted to prevent Section 115(g) being retroactive. It is, however, no longer necessary, because the proposed income tax title applies only to 1932 and subsequent years."

[3] The first section of the Revenue Act of 1934 says:

> "The provisions of this title apply only to taxable years beginning after December 31, 1933."

This was interpreted by the House and Senate committees in the same manner as the analogous provision in the 1932 act. The committee reports say:

> "The Bill follows the general plan and arrangement of the Revenue Act of 1932. The income tax title is made applicable to taxable years beginning after December 31, 1933."

ther, such decision decided an important question of federal law which has not been, but should be, expressly settled by this Court, although, to be sure, such decision was in conflict with the principle announced in an analogous decision of this Court not passing upon the point directly. Both the District Court and the Circuit Court of Appeals below were of the opinion that a winding up of a business must be contemplated, or at least a policy of contraction manifested in order to have a "partial liquidation" under paragraph (i) of Section 115 of the Revenue Act of 1934. The Circuit Court of Appeals below recognized that this was not the rule according to the decision of another Circuit (R. 101).

In *Commissioner* v. *Quackenbos*, 78 Fed. (2d) 156, 157 (C. C. A. 2, 1935), the Court of Appeals of the Second Circuit said:

> "A redemption of part of the stock of a corporation whether it be all of a class such as of preferred stock, or of a part of the common stock, has no necessary relation to the winding up of a corporation."

The Board of Tax Appeals also expressly held to the same effect in *Salt Lake Hardware Co.* v. *Commissioner*, 27 B. T. A. 482 at 486.

Even without the decisions of the Board of Tax Appeals and the Second Circuit, it would appear to be clear that the definition given in paragraph (i) of Section 115 makes "a distribution in partial liquidation" *words of art* for the purposes of Section 115. This was inferentially recognized by this Court in *Foster* v. *U. S.*, 303 U. S. 118, 121, 58 S. Ct. 424, 82 L. Ed. 700 (1938). The facts in that case as shown by the findings of the Court of Claims, *17 Fed. Supp. 191, 192*, were that the corporation there continued to make handsome profits, paid large dividends, manifested no policy of contraction, and had no idea of winding up the busi-

ness when it redeemed a portion of its stock. Yet this Court held that the redemption of stock and distribution in that case was a partial liquidation, properly chargeable to capital account under subsections (c) and (h) (now subsection [i]) of Section 115 (303 U. S. 121).

We believe the Court should decide whether subsection (i) of Section 115 of the Revenue Act of 1934, and analogous sections in previous and subsequent acts gives a special meaning to "a distribution in partial liquidation" as therein defined, or whether popular conceptions of liquidation override the congressional definition.

V

The Circuit Court of Appeals decided another Federal question in a way probably in conflict with applicable decisions of this Court. The decisions below held that since the corporation had on hand sufficient accumulated earnings since February 28, 1913, from which to have made the distributions in the cases at bar, such distributions of the par value of stock previously canceled by the corporation upon a reduction of its authorized and paid-up capital, were not properly chargeable to capital account nor non-taxable under subsections (i) and (c) of Section 115 of the Revenue Act of 1934, but were taxable as dividends under subsections (a) and (b) of that Section.

This Court in *Jerome* v. *Cogswell*, 204 U. S. 1, 51 L. Ed. 343, 27 S. Ct. 241 (1907), held that where the unimpaired capital of a corporation is reduced and par value stock canceled, the corporation owes the par value of the canceled stock as a debt to the shareholders whose stock is canceled.[4]

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[4] To like effect see *Seeley* v. *N. Y. Nat. Exch. Bank of N. Y.*, 8 Daly (N. Y.) 400, Aff. 78 N. Y. 608 (1879); *Roberts* v. *Roberts-Wicks*, 92 N. Y. S. 387, 102 App. Div. 118 (1905); *In Re Artisans Land & Mort. Corp.*, 1904 L. R. 1 Chancery 796; *Thompson on Corporations*, 3rd Ed. Vol. 5, Sec. 3695; *Fletcher's Cyclopoedia of the Law of Corporations*, Vol. 11, Sec. 5150; *Morawetz on the Law of Private Corporations*, 2d Ed. Vol. 1, Sec. 443.

Similarly in the cases at bar the corporation owed a debt to the stockholders whose stock was canceled in 1914. When this debt was paid in 1934, by the distribution in question, it was necessarily a return of capital and properly chargeable to capital account.

In *Foster* v. *U. S.*, 303 U. S. 118, 121, 58 S. Ct. 424, 82 L. Ed. 700 (1938), this Court likewise held that a distribution in cancellation of part of an issue of stock was properly chargeable to capital account under subsections (c) and (h) (now [i]) of Section 115. The decisions below were directly contrary to the *Jerome* and *Foster* cases decided by this Court.

To hold that the distribution here be not considered a return of capital but dividends, requires Mrs. Rheinstrom to make a *nunc pro tunc* gift of $36,600 to Karl Kiefer. The preferred stock in the cases at bar had no limitation as to its right to share in the surplus on final liquidation, and therefore under *Continental Ins. Co. et al.* v. *U. S. et al.*, 259 U. S. 156, 181, 66 L. Ed. 871, 888, 42 S. Ct. 540 (1922), had equal right per par value with the common stock to share in the surplus upon liquidation. Because of this, by the reduction in the common stock without reduction in the outstanding preferred stock, which was all held by Karl Keifer, Mrs. Rheinstrom's proportionate ownership in the corporation was reduced approximately from two-fifths to one-fifth, and Karl Kiefer's proportionate ownership was increased from approximately three-fifths to four-fifths. (See calculation on page 23 of appellant's brief in the Court of Appeals, part of Appendix B to this petition.) This is conceded by the Circuit Court of Appeals (R. 105).

The Circuit Court of Appeals, in spite of the foregoing, and the decision of this Court in *Koshland* v. *Helvering*, 298 U. S. 441, 80 L. Ed. 1268, 56 S. Ct. 767 (1936), con-

sidered the proportionate stock ownership of the corporation virtually untouched, citing *Eisner* v. *Macomber,* 252 U. S. 189 (R. 103), which case is inapplicable on the point, because of the preferred stock factor in the cases at bar.

Thus the decision below deprived Mrs. Rheinstrom of her right to receive one-half of the $122,000 surplus created by the reduction of capital, which *Jerome* v. *Cogswell, supra,* says was a debt due her, but instead entitled her to receive only one-fifth thereof, a difference of $36,600, which under *Continental Ins. Co. et al.* v. *U. S. et al., supra,* will accrue to Karl Kiefer. Surely such a *nunc pro tunc* gift cannot be forced upon Mrs. Rheinstrom within due process of law.

VI

The Circuit Court of Appeals has sanctioned such a departure by the District Court from the accepted and usual course of judicial proceedings as to call for an exercise of this Court's power of supervision. The petitioners in the trial court sought to introduce evidence from the director and stockholder who proposed the resolutions reducing the capital in 1914, that the purpose of the reduction was to create a surplus due the stockholders which they could draw down at any time at their election so as to have money available to make outside investments if they so desired (R. 31-33). This testimony clearly showed that it was the intention of the parties involved to have the surplus created by the reduction of capital belong to the stockholders whose stock was canceled. No tax saving could have been effected at the time and the Government has never even suggested any purpose for the reduction other than that brought out by the proposed testimony. Such testimony tended to show that the stockholders intended in fact what *Jerome* v. *Cogswell, supra,* requires as a matter of law. The District Court rejected the testimony on the ground of the parol evidence rule (R. 30, 31, 41).

This was contrary to the rule in Ohio, which governs the cases here, and which merely follows the general rule, that the bar of the parol evidence rule cannot be raised by anyone who is not a party to the transaction even if that person be a Tax Collector.

Bowman v. *Tax Com. et al.*, 135 O. S. 295, 16 N. E. (2d) 459 (1939), approving *Platt* v. *Huron Co. Banking Co.*, 50 O. S. 528, 35 N. E. 308 (1893). See also *Jones' Commentaries on Evidence*, 2nd Ed. Sec. 1488.

Furthermore, corporate resolutions, since they are not of a contractual nature and do not define rights, are not the kind of instruments to which the parol evidence rule applies.

Lawrence v. *Premier Indemnity Ins. Co. et al.*, 180 Cal. 688, 182 Pac. 431 (1919);
Daggett v. *St. Paul Tropical Development Co.*, 141 Minn. 51, 169 N. W. 252 (1918);
Cook v. *Manasquan*, 80 N. J. L. 206, 76 A. 310 (1910);
Butts v. *Gaylord State Bank*, 156 Misc. 555, 282 N. Y. S. 1 (1935).

Also, even if the parol evidence rule were otherwise applicable, it would not prohibit evidence of purpose.

Bowman v. *Tax Com. et al.*, 135 O. S. 295, 16 N. E. (2d) 459 (1939);
Third Nat. Bank v. *Laidlaw*, 86 O. S. 91, 100, 98 N. E. 1015 (1912);
Merchants Nat. Bank v. *Cole*, 83 O. S. 50, 93 N. E. 465 (1910);
Morgan v. *Boyer*, 39 O. S. 324 (1883).

This is also the rule of this Court, *Brick* v. *Brick*, 98 U. S. 514, 25 L. Ed. 256 (1878).

In its opinion the trial court adhered to its exclusion of the evidence, but stated that it would not have been persuaded by it even if admitted (R. 62-63). The Circuit Court of Appeals held that if the exclusion was error, it was

harmless because the trial court had thus considered it in its findings, and because counsel for petitioners stated that the evidence showed the stockholders intended only what followed as a matter of law.

It is submitted that the citations above clearly show that the exclusion was error. Surely, exclusion of such important evidence is not rendered harmless merely because it shows the stockholders intended their rights to be what *Jerome* v. *Cogswell* held them to be as a matter of law, nor because the trial court, to excuse its error, says that it would not have been persuaded by the testimony even had it been admitted.

Is not the proper criterion of prejudice, whether such testimony is calculated to have a material effect on the decision of any reasonable court or jury, not whether a particular Judge considered it persuasive on his own mind?

This Court has never decided whether the parol evidence rule can be raised by the Government in a tax case. Also, it should not permit the error of exclusion of such vital evidence as in the cases at bar to be considered harmless.

VII

The Circuit Court of Appeals has decided another important question of Federal law which has never been, but should be, settled by this Court, to-wit: does it violate due process of law and the apportionment of requirements of *Art. 1, Sec. 2, Clause 3,* and *Section 9, Clause 4 of the Federal Constitution*[5] to cast the burden of an income tax on dividends upon remaindermen under a trust who are not

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[5] Article I, Section 2, Clause 3, reads in part:

"Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers. . . ."

Article I, Section 9, Clause 4, reads:

"No Capitation, or other direct Tax shall be laid, unless in Proportion to the Census or Enumeration hereinbefore directed to be taken."

entitled to receive dividends, but entitled to receive capital only? Under the will of Karl Kiefer, deceased, the petitioner bank, as trustee, was to hold one-third of his estate in trust, paying the income thereon for life to Adele Kiefer, and upon her death to pay the principal to designated remaindermen (R. 84). Upon this one-third of the Kiefer portion of the distribution, the petitioner bank, as trustee, was required to pay the income tax in dispute in this case.

Under the terms of the trust, if the distribution was income, the life tenant was entitled to the same, and the life tenant, not the trustee, is required to pay the income tax thereon, whether or not the life tenant actually received the distribution. *Freuler* v. *Helvering*, 291 U. S. 35, 78 L. Ed. 634, 54 S. Ct. 308 (1934).

The Commissioner of Internal Revenue, however, held that the tax was not payable by the life tenant (R. 59-60, 87). Instead the respondent required the trustee bank to pay the income tax on the distribution although the trustee held the same as principal under the will (R. 85). The effect of all this was to charge the remaindermen who are not entitled to receive any income but only entitled to receive principal with a tax on a distribution which can be upheld only if it is income. In other words, if the distribution was income the life tenant should have paid the tax; if it was principal, it is properly chargeable to capital account and not taxable at all. Can the interest of the remaindermen entitled to capital only thus be charged with a tax on income? Does not such action violate due process of law?

Furthermore, if the distribution is capital, *Art. I, Section 2, Clause 3*, and *Section 9, Clause 4*, of the Federal Constitution is violated, because the tax is not apportioned among the several states in accordance with population.

Wherefore, your petitioners respectfully pray that writs of certiorari be issued out of and under the seal of this Honorable Court directed to the United States Circuit Court of Appeals for the Sixth Circuit commanding that Court to certify and send to this Court for its review and determination on a day certain to be named therein, a transcript of the record and proceedings in both cases herein, and that the judgments of said United States Circuit Court of Appeals for the Sixth Circuit in both cases herein may be reversed by this Honorable Court, and that your petitioners may have such other and further relief in the premises as to this Honorable Court may seem meet and just.

Respectfully submitted,

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